Arizona State Senate
Background Brief

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Note to Reader:

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MUNICIPAL BONDS & ARIZONA STATE, LOCAL & COUNTY DEBT

INTRODUCTION

Government capital facilities (buildings and structures) may either be paid for with current income on a "pay-as-you-go" basis or financed by borrowing money and making payments over time. Typically the financing necessary is approved through the sale of bonds. Most state and local government bonds are collectively referred to as "municipal bonds" or "tax-exempt bonds," because the interest paid on them is exempt from federal income tax. In many cases the interest income on municipal bonds is also exempt from income taxes in the state of issuance and local income taxes, if applicable.

TYPES OF DEBT

Municipal bonds can be categorized into two types: general obligation (GO) bonds and revenue bonds. GO bonds are secured by the "full faith and credit" of the government, that is its full taxing power. There is a legal obligation to use its taxing power, if necessary, to repay the debt, and in the event of a default the holders of GO bonds have a right to compel a tax levy to meet the obligation. GO bonds are considered to be very low risk for investors, and they usually sell at the lowest rates of interest.

Revenue bonds are legally secured only by a specifically identified revenue source rather than the full faith and credit of the government. If that revenue source is inadequate to make the debt service payments, the government is not legally obligated to use any other revenues for the bond payments. The government may pledge a certain portion of specific tax revenues or may use revenue generated from the operation of a project financed with the bonds to pay the principal and interest. Thus, revenue bonds are typically used to finance revenue producing projects such as sports venues, convention centers, hydroelectric projects or airports. The revenues subsequently generated from the operation of the project are used to pay off the bonds. Usually, revenue bonds do not require voter approval, although an election may be required by law in particular cases. Often revenue bonds are considered riskier than GO bonds and therefore carry a higher interest rate. Although a government issuer is not legally obligated to repay the bonds from any other source if it were to default on its revenue bonds there would be a negative reaction in the bond market that may adversely affect the government's future credit ratings.

THE BOND MARKET

The municipal bond market is governed by extensive formal, specialized laws and practices intended to provide a secure, fair and dependable process for the borrowing and repayment of monies by government agencies. There are over 2,000 banks and securities firms that are registered to buy and sell municipal bonds. Independent rating agencies analyze the creditworthiness of the government entity issuing the bonds in order to measure the probability of timely payment of principal and interest to assist investors in evaluating the bond's degree of risk. A high credit rating means a lower risk of default and a lower interest rate. Municipal bonds are usually sold in denominations of $5,000 or multiples of $5,000. Because returns on municipal bonds are exempt from federal taxes, and in certain cases from state and local income taxes in the state of issuance, investors are willing to accept lower interest rates (yields) because the tax savings will make up and perhaps exceed the difference in yield between municipal bonds and other investments of similar risk. This enables governments to borrow money at a significantly lower interest rate compared to the rates if the interest were taxable.

ARIZONA DEBT LIMITATIONS

The Arizona Constitution requires voter approval before the issuance of GO bonds. Additionally, the Arizona Constitution limits the amount of GO debt that the state may incur to $350,000. The state courts have held that the limitation does not apply to revenue bonds or other debt that is repaid only from specifically designated revenue sources. See *Arizona State Highway Commission v. Nelson*, 105 Ariz. 76 (1969). This interpretation allows the State Transportation Board to issue special revenue bonds to construct state highways, payable from fuel and motor vehicle taxes, the Arizona Board of Regents to issue "tuition revenue" bonds to fund university facilities, payable from tuition and other fees, and certain other entities to borrow for capital projects by utilizing a lease-purchase financing mechanism known as "certificates of participation" (COPs). COPs enable a lender to be paid back by government agencies who are tenants of COP financed buildings through rent type payments.

State law specifically authorizes county, city and town debt financing for several purposes, including street and highway improvements and utilities. The Arizona Constitution limits county and municipal GO debt to six percent of "the taxable property" (net assessed secondary property valuation) of the county or municipality, however voters may authorize a county, city or town to incur additional debt beyond the six percent limit under certain conditions and limitations specified in state law. Borrowings that are secured by specific, special revenues or that do not exceed one year in length, including future obligations that are subject to the availability of annually appropriated monies, are not subject to constitutional debt limitations. See *City of Phoenix, v. Phoenix Civic Auditorium and Convention Center Association*, 100 Ariz. 101 (1966). School districts, like counties and municipalities, are authorized to incur debt and are subject to similar debt level limitations.

Municipal bonds issued by a government entity in Arizona are exempt from the state income tax.

Special Districts

Arizona Statute authorizes the creation of special taxing districts. Special districts are local governments that have very limited areas of jurisdiction. These include school districts, community college districts, irrigation districts, flood control districts and others. Generally, special districts are authorized to levy taxes or assessments on the general public, usually in the form of taxes or assessments on property, and may borrow money to finance their operation, secured by their general taxing power, and are governed by elected boards of directors. Special districts are exempt from the Arizona debt limitations on counties and municipalities.

Public Authorities

In Arizona, a public authority (e.g., Greater Arizona Development Authority and the Arizona Power Authority) is similar to a special district except that an authority does not have the power to levy general taxes or assessments and, consequently, cannot issue GO bonds. Authorities may issue revenue bonds that are secured by whatever reliable source of revenues they may have.

Short-Term Debt

Sometimes governments may incur short-term debt, for cash flow reasons. For example, this may be necessary if a government's expenditures typically occur earlier in the fiscal year than revenues are received. Short-term notes are written promises to repay a specified principal amount on a date certain, usually within one year, with interest at a stated rate, payable from a specific source of anticipated revenue. Interest on short-term notes is usually paid on maturity.

ADDITIONAL RESOURCES

- "Arizona Legislative Staff Guide to State and Local Bonds and Debts," Arizona Legislative Council, November 2005
- "Fundamentals of Municipal Bonds; New York," Public Securities Association, Fourth Ed., 1990